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Economy Contracting

Business Cycle Report of August 2008

The Austrian economy grew at a seasonally and working day adjusted quarter-on-quarter rate of 0.4 percent in real terms in the second quarter of 2008, according to WIFO's flash estimate. In year-on-year terms, GDP growth was 2 percent. The marked deceleration in growth from previous quarters reflects the impact of the global economic downturn on export activity and industrial production. Consumer demand cannot recover on the back of high inflation and declining real incomes. The construction sector and tourism, on the other hand, stabilise the economy. Labour market conditions remain very favourable, compared with last year, but there are already clear signs of a trend reversal.

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The global economic downturn emanated from the USA and, exacerbated by the high euro exchange rate and the marked rise in consumer prices, in early summer spread also to the euro area. It is now beginning to show also in Austria. GDP growth declined to just 0.4 percent in real terms quarter-on-quarter in the second quarter of 2008. The economic upswing that started in 2004 has thus come to an end.

The trend reversal first became apparent in the export-oriented industry. Exports rose at a seasonally adjusted quarterly rate of 0.9 percent in real terms in the second quarter, or by 4.6 percent year-on-year (goods exports +5.4 percent). Hence, exports expanded at only half the pace of a year before. While according to the Foreign Trade Statistics demand from East Central Europe and the oil-producing countries remained strong, it was merely subdued for the euro area and even declined in the USA due to weak domestic demand there. Real value added growth in the Austrian manufacturing sector fell to just 0.6 percent quarter-on-quarter in the second quarter (seasonally adjusted), a marked decline compared with the two previous quarters, which had been particularly strong (+1.5 percent in each quarter). Compared with a year earlier, the growth rate was still 4.9 percent recently.

The results of the WIFO business survey also confirm that manufacturing activity is slowing. The surplus of companies anticipating an increase in production is falling quickly (from 16.5 percentage points in the third quarter of 2007 to only 7 percentage points in the third quarter of 2008). Companies now assess their order books clearly less positively and report a decline in capacity utilisation levels and a rise in inventories. While a year ago the balance of industrial companies that were optimistic regarding their own business situation in six months' time was still positive at +8 percentage points, companies now give a predominantly negative assessment of the business outlook (-9.5 percentage points). The European Commission, in its business survey about industrial activity in the EU, obtained similar results. A particularly strong deterioration in business sentiment since the beginning of the year was recorded for France, Spain and Finland, but also for the Baltic countries.

While in Austria it was not until very late that the economic upswing of recent years fed through into business spending on machinery and equipment, investment has grown until recently. In the second quarter of 2008, business spending on machinery and equipment rose at a seasonally adjusted quarterly rate of 0.6 percent in real terms (+5.4 percent year-on-year), according to WIFO's flash estimate. Investment

intentions of the manufacturers participating in the WIFO investment survey were still rather optimistic in early summer. It remains to be seen, however, to what extent these plans will be realised given the decline in incoming orders and capacity utilisation levels.

Table 1: Flash estimates of quarterly national accounts

	2007				2008	
	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
Adjusted for seasonal and working day effects, percentage changes from previous quarter, volume						
<i>GDP, expenditure approach</i>						
Final consumption expenditure						
Households ¹	+ 0.1	+ 0.2	+ 0.2	+ 0.3	+ 0.2	+ 0.3
General government	+ 0.0	- 0.1	+ 1.6	+ 1.1	- 1.8	+ 2.5
Gross capital formation	+ 0.7	+ 0.5	+ 0.4	+ 0.3	+ 0.4	+ 0.5
Exports	+ 2.3	+ 2.0	+ 1.6	+ 1.4	+ 1.0	+ 0.9
Imports	+ 1.9	+ 1.4	+ 1.7	+ 1.1	+ 0.3	+ 1.6
Gross domestic product	+ 0.8	+ 0.7	+ 0.6	+ 0.7	+ 0.6	+ 0.4
<i>GDP, output approach</i>						
Agriculture, forestry	+ 7.6	- 0.2	+ 1.4	+ 0.9	- 1.3	- 1.8
Industry, including energy	+ 0.9	+ 0.9	+ 1.2	+ 1.6	+ 1.1	+ 0.5
Construction	+ 0.6	+ 0.4	+ 0.4	+ 0.5	+ 0.5	+ 0.5
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.6	+ 0.5	+ 0.5	+ 0.5	+ 0.5	+ 0.2
Financial intermediation; real es- tate, renting and business activities	+ 0.8	+ 0.8	+ 0.9	+ 0.7	+ 0.5	+ 0.7
Other service activities	+ 0.1	+ 0.2	+ 0.3	+ 0.4	+ 0.3	+ 0.1
Taxes on products	+ 0.5	+ 0.4	+ 0.3	+ 0.3	+ 0.3	+ 0.2
Subsidies on products	+ 1.3	+ 1.1	+ 1.0	+ 0.8	+ 0.6	+ 0.7
Percentage changes from previous year						
Gross domestic product, volume	+ 3.8	+ 3.2	+ 2.7	+ 2.6	+ 2.7	+ 2.0

Source: WIFO. – ¹ Including private non-profit institutions serving households.

The high inflation rate also represents a drag on economic activity. In Austria, HICP inflation reached the 4-percent mark (CPI +3.9 percent) in June; this mark was already exceeded in the euro area in July (Eurostat flash estimate: +4.1 percent). Three fifths of domestic inflation can be attributed to price increases for fuel, heating oil and food. Recently there have been signs of prices in these product categories beginning to ease moderately. World market prices for crude oil fell from a record high of more than 140 \$ per barrel to just under 120 \$. Consumer prices for food receded slightly in June compared with May. Nevertheless, the marked upward drift in prices implies a decline in gross real income per person employed since nominal contractual wages rose by just 3.3 percent on average. The weak growth of disposable incomes is feeding through into household consumption. In the second quarter of 2008 it expanded by 0.3 percent in real terms from the previous quarter (seasonally adjusted). In year-on-year terms, the growth rate was only 0.8 percent. Real retail sales growth in the first six months was also only of the same magnitude.

The construction sector and tourism, on the other hand, stabilise the economy. Real construction sector value added grew by 0.5 percent quarter-on-quarter and 3 percent year-on-year in the second quarter. While the demand for residential construction is receding, industrial and commercial building construction is lively, and civil engineering activity is expanding from a very high level. Hence construction activity is much stronger in Austria than on EU average, the latter being dragged down by the real estate and construction crisis in Ireland, Spain and the UK. Austria's tourist sector reported a good start of the summer season despite the fact that the number of overnight stays during the European football championship in June was down 4 percent from a year earlier, in part also due to calendar variation. Overall, tourism sales in May and June were up 4.3 percent in real terms from a year before.

Labour market conditions continue to improve noticeably compared with a year earlier. The number of persons in dependent active employment rose by 79,000 in

July from a year before, that of persons registered as unemployed fell by 7,000 from a year before. The seasonally adjusted figures show a trend reversal in the labour market attributable to the given state of the economy, however: employment is rising only moderately (July +0.1 percent month-on-month), the number of job vacancies is falling (-2.6 percent), and the number of unemployed persons is beginning to rise (+0.6 percent).

The US economy grew only modestly in the second quarter of 2008 (+0.5 percent in real terms quarter-on-quarter and +1.8 percent year-on-year, respectively), but recession failed to materialise. A major contribution to GDP growth came from net exports. Benefiting from the low dollar exchange rate, exports increased by 10 percent or more from a year earlier. Imports, on the other hand, declined due to weak domestic demand, resulting in a very high contribution to growth from net exports. Household spending rose by 1.3 percent in real terms year-on-year. The dampening impact of the weak growth of real incomes contrasted with the expansionary effect of \$ 78 billion in tax rebates (½ percent of GDP in 2008) paid out in the second quarter. The decline in residential investment continues to have a particularly strong negative effect on economic activity, however (Q2 -20 percent year-on-year). Domestic demand has been contracting moderately in real terms since the fourth quarter of 2007.

Recent economic indicators suggest that the economic situation will remain unfavourable. The housing market is not expected to ease any time soon, given the continued sharp fall in house prices, the financial crisis continues unabated, the unemployment rate has risen markedly since April (July 5.7 percent of the labour force), surging energy and food prices are eroding disposable incomes (June inflation rate 5 percent), value added growth in both the industrial and services sectors is stagnating. Economic policy is providing support to the economy, though: The low dollar exchange rate benefits exports, and interest rate policy follows an expansionary stance. The supportive effect of the tax rebate cheques on the economy is likely to subside in the third quarter, though.

According to the European Commission's Economic Sentiment Indicator, confidence in the economy plunged in the EU in mid-2008. The boom in industry has come to an end, and companies' assessment of incoming orders has deteriorated markedly lately. Capacity utilisation stood at 82.8 percent at the beginning of the third quarter, just under 2 percentage points below its record high in the second quarter of 2007, but still above its long-term average (81.5 percent). Industrial production, by contrast, has already contracted; in May it was 1.1 percent lower than in January 2008 and only 0.9 percent above the year-earlier level. The situation in the construction sector has also deteriorated, largely due to the slump in Ireland, Spain and UK. The services sector, which depends more strongly on consumer demand, has had only little part in the economic upturn of recent years. This sector has also seen business sentiment darken lately. Consumer confidence has been deteriorating since spring, notably in response to shrinking real incomes due to accelerating inflation. In June, euro area retail sales dropped by 1.5 percent in real terms compared with January 2008 (EU -0.8 percent), and by 1.7 percent year-on-year (EU -0.5 percent).

Economic developments in the second quarter were particularly unfavourable for Austria's most important trading partners. Following an extremely strong first quarter, GDP growth in Germany appears to have slowed in seasonally adjusted quarter-on-quarter terms in the second quarter. Given its high dependence on exports, Germany's economy is affected to an exceptionally high degree by the global economic slowdown. The Italian economy has been stagnating since mid-2007, with real GDP growth declining by 0.3 percent quarter-on-quarter in the second quarter.

Exports and tax cheques provide support to US economy

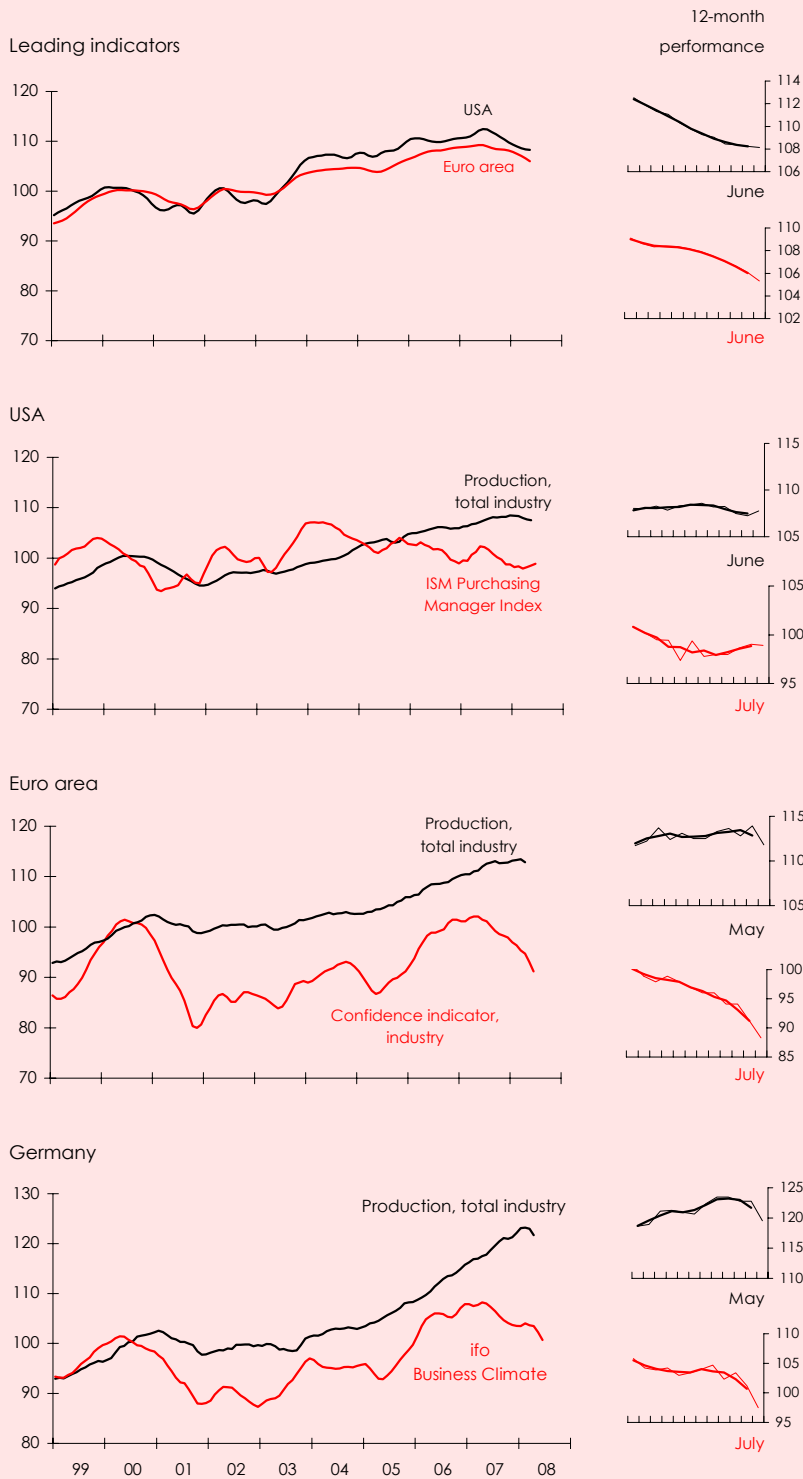
Strong exports and household consumption helped by tax rebate cheques have kept the US economy going in the second quarter, but the financial and real estate crisis continues to exert a dampening impact.

Economic slowdown in the EU

Business surveys show that sentiment in the EU has darkened, notably in industry and among consumers. Economic policy faces the difficult challenge of high inflation and rising unemployment.

Figure 1: International business climate

Seasonally adjusted, 2000 = 100, 3-month moving average



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply ManagementTM), ifo (Institute for Economic Research, Munich), OECD.

Inflation averaged 4.1 percent in the euro area in July, according to Eurostat's flash estimate. Consumer price inflation, driven largely by soaring oil and food prices on the world market, has thus picked up further. The high inflation rate in July, which was outside the European Central Bank's target range, prompted the ECB to raise the minimum bid rate on its main refinancing operations to 4.25 percent. At the

same time, however, it provided substantial additional liquidity to banks suffering from the impact of the ongoing financial crisis.

The euro area seasonally adjusted unemployment rate hit its low in spring, at 7.2 percent of the labour force; since May, the economic slowdown has been reflected in a – for the present slight – increase (June 7.3 percent). Spain and Ireland already recorded a sharp increase in unemployment.

Manufacturing is that sector which in Austria shows the strongest reaction to cyclical fluctuations. Following vigorous expansion in recent years up to the first quarter of 2008, growth in this sector slowed to a seasonally and working day adjusted rate of just 0.6 percent in real terms quarter-on-quarter, or 4.9 percent year-on-year, respectively, according to the national accounts. The results of the WIFO business survey suggest a further slowdown in industrial activity in the third quarter. The surplus of companies with positive production expectations has declined from +16.5 percentage points a year ago to just 7 percentage points now. The assessment of order books has deteriorated markedly, with companies complaining about declining capacity utilisation levels and rising inventories. The balance of expectations regarding business conditions in six months' time fell to –9.5 percentage points, from +8 percentage points in the third quarter of 2007. The economic downturn has hit the entire domestic manufacturing sector, from the base sector and the chemical industry to construction suppliers and consumer goods manufacturers. It is less marked only in the technical processing sector (steel, motor vehicle, metal-working and electrical goods industries).

Austria's manufacturing industry is very export-oriented. The observed economic slowdown is reflected also in the export data of Statistics Austria, which are available only with a lag, however. From January to May, merchandise exports rose by 5.4 percent in nominal year-on-year terms, whereas the average increase in 2007 had still been 10.5 percent. Exports to East Central Europe and to the oil-exporting countries continued to grow vigorously at the beginning of 2008. Euro area demand, by contrast, expanded by a mere 3 percent, while demand from the USA contracted.

With economic activity cooling, it remains to be seen to what extent Austrian manufacturers will realise their investment intentions, which had still been rather optimistic in spring¹.

While the construction sector benefited from the mild weather at the beginning of 2008, output developments remained favourable also in the second quarter. Real value added growth was up 3 percent from a year before, and construction investment even rose by 4.9 percent. Infrastructure construction is steadily expanding due to sustained demand from the public sector. Industrial and commercial construction firms report an increase in new orders received. This is consistent with the results of the WIFO investment survey for the manufacturing sector according to which companies plan to expand especially their construction investment. Only residential construction is moderating. In the WIFO business survey, construction firms expect the sharp increase in prices to continue.

The inflation rate has been above the 3-percent mark since November 2007, reaching 3.9 percent in June, its highest level in 15 years. On a month-on-month basis, consumer price inflation was 0.3 percent, 1.6 percent, and thus almost half of overall inflation was attributable to increases in the prices of fuel and heating oil. World market prices for crude oil rose further in July, but have eased considerably lately. Higher food prices – notably for dairy and grain products – added another 0.8 percentage point to overall inflation in Austria. Prices in these groups of products eased

Sentiment deteriorating in Austrian industry

Suffering from the impact of slackening global activity, the manufacturing industry has significantly revised down its production expectations.

Construction sector performing favourably

Industrial and commercial construction firms report an increase in order volumes, and the civil engineering sector is expanding steadily; residential construction, by contrast, shows first signs of slowing.

Inflation rate close to 4-percent mark

¹ See Falk, M., Schwarz, G., "Sachgütererzeugung will Investitionen 2008 weiter steigern. Ergebnisse des WIFO-Investitionstests vom Frühjahr 2008", WIFO-Monatsberichte, 2008, 81(8), http://www.wifo.ac.at/www/jsp/in dex.jsp?fid=23923&id=33286&typeid=8&display_mode=2.

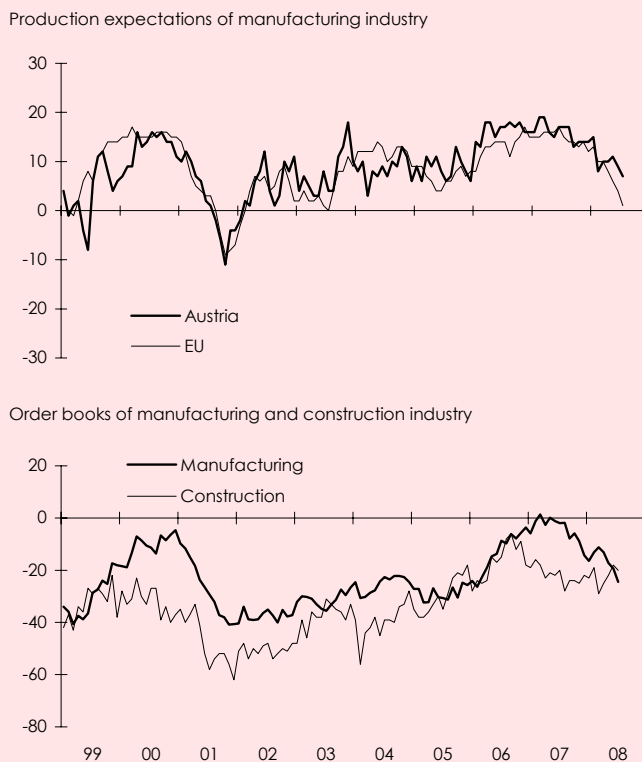
somewhat in June from a month before. Only telephone and internet charges declined compared with a year earlier. The persistently strong upward pressure on prices in the economy as a whole is also reflected in wholesale prices, which in June and July were up more than 11 percent compared with a year before.

Contractual wages rose by just 3.3 percent year-on-year during the first half of the year. Hence, inflation also outstripped gross wage gains. After deduction of taxes and other charges, wage and salary earners are faced with substantial real income losses. Pensioners are hit even more severely by the loss in purchasing power. Minimum pensions were raised by 2.9 percent in nominal terms in 2008, while for all other pensions the rate of increase was lower.

Rising fuel, heating oil and food prices are the main factor behind price developments. Inflation recently exceeded contractual wage increases by ½ percentage point or more.

Figure 2: WIFO business cycle survey

Differences between the percentage shares of correspondents giving positive and negative replies, seasonally adjusted



Source: European Commission, WIFO business cycle survey.

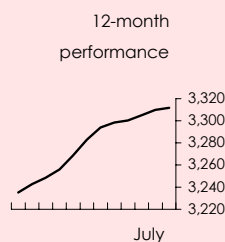
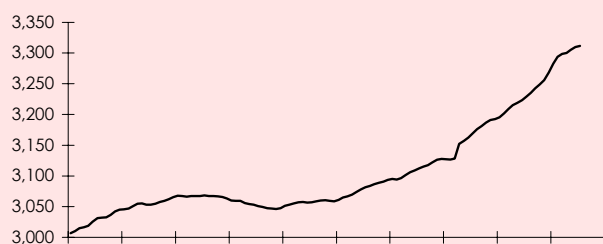
Weak disposable income growth has dampened household demand for years. The strong upward pressure on prices now exacerbates this development. In the second quarter, private consumption once more rose at a seasonally and working day adjusted quarter-on-quarter rate of only 0.3 percent in real terms. On a year-on-year basis, the real growth rate was just 0.8 percent.

This substantial weakness of consumer demand is also reflected in retail sales developments: During the first half of the year real retail sales rose by 0.9 percent compared with the same period a year earlier; for June, Statistics Austria even reports a decline by 2.9 percent, most likely due largely to accelerating inflation.

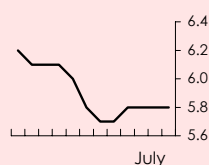
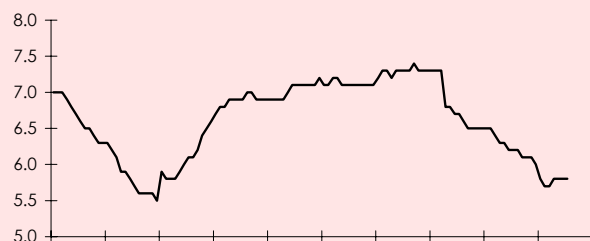
Subdued consumer demand, strong tourism

Figure 3: Key economic indicators

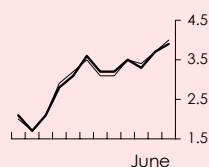
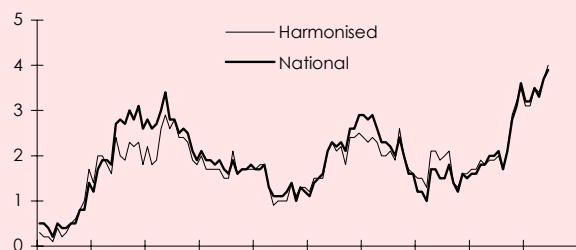
Persons in active dependent employment¹, (1,000), seasonally adjusted



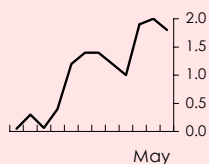
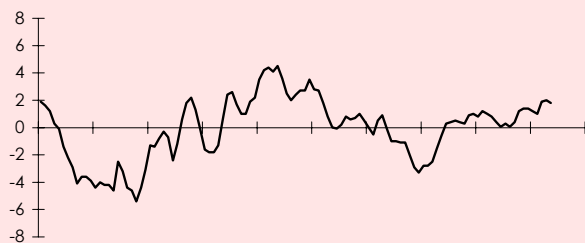
Unemployment rate, traditional Austrian method², seasonally adjusted



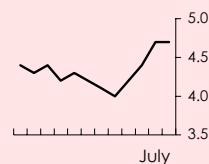
Consumer prices, year-to-year percentage changes



Real effective exchange rate, year-to-year percentage changes



10-year central government bonds (benchmark), percent



Source: Public Employment Service Austria, Federation of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – ¹ Excluding parental leave, military service, and unemployed persons in training. – ² As a percentage of total labour force excluding self employed, according to Public Employment Service.

The European Football Championship did not provide any stimulus in June: Austrian tourism enterprises recorded a year-on-year decline in overnight stays by 4.1 per cent – in part also due to fewer holidays. Overall, however, developments in the tourism industry continued to be favourable at the beginning of the summer season, with the number of overnight stays recorded in May exceeding the year-earlier level by 16 percent. The demand from Russia and East Central Europe continues to grow at a particularly vigorous pace. That from Germany is almost flat, whereas the number of overnight stays by guests from the USA declined by 22 percent in May and June compared with the same period a year earlier, a result of the strong euro and the weak economy in the USA.

The labour market reacts with a lag to the cooling economy. Labour market conditions remain favourable, especially compared with last year. In July, 3,399,800 persons were in dependent active employment, an increase by 79,000 from a year earlier, whereas 178,700 persons were registered as unemployed with the Public Employment Service, a decline by 6,800. Hence, the unemployment rate stood at 4.8 percent of the dependent labour force. Recently, the ratio of one registered job vacancy to unemployed persons was only 1 to 4.

But the seasonally adjusted figures give a first indication of a trend reversal in the domestic labour market: Employment growth receded significantly to a month-on-month rate of only 0.1 percent in June and July. The number of job vacancies is declining – 37,000 job vacancies were registered in July, a drop by 2.6 percent from a month before. The seasonally adjusted number of unemployed persons fell from its record high of 257,000 in September 2005 to 207,000 in the spring of 2008. It has been rising moderately since then, to 211,000 in July, an increase by 0.6 percent from June. In July, the seasonally adjusted unemployment rate stood at 5.8 percent of the dependent labour force.

Muted real income growth has a dampening impact on consumer spending. Real retail sales hardly increased at all in the first half of the year.

Marked deceleration of strong employment growth

Labour market conditions have improved further compared with a year earlier. However, the seasonally adjusted figures already indicate a softening due to the prevailing economic situation, with companies hiring hardly any additional labour since spring.